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# The Question of Regulating Illegal Markets

## The gambling and cannabis markets in the Netherlands

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**Abstract—** Decriminalizing and regulating an illegal market may be a useful strategy for reducing crime. It is also necessary, however, to have a clear understanding of the nature of the illegal market before undertaking such an endeavor. Experiences in the Netherlands show that regulation of formerly illegal markets may indeed result in a substantial reduction of organized crime and other criminal activities, if the regulatory system is designed adequately. These experiences also show that such systems inherently lack flexibility and that criminals are usually quick to re-enter the market when unforeseen developments, particularly technical innovations and internationalization, create new illegal business opportunities.

### I. INTRODUCTION

Criminalization may be understood as a related set of intentional activities attempting to control, order, or influence the behavior of others [1]. The same applies to decriminalization. In particular, if an activity is illegal for moral reasons as well as because of its harmful effect on society, there may be room for decriminalization. If customer demand for certain illegal goods and services remains high, it will be very difficult to curb illegal markets by means of repressive action, and regulation may result in less crime and health problems and social disorder. Gambling, narcotic drugs and prostitution are examples of markets where there has been a fierce discussion on the pros and cons of criminalization. The debate is highly politicized, and there are still large differences across the world regarding the extent to which individual states have regulated parts of the aforementioned activities. Decriminalization of (parts of) the gambling market is now common in many countries. All of the Member States of the European Union (EU), for example, have now regulatory systems for all or most types of gambling [2,3]. The Netherlands, however, is unique in the extent to which it has also regulated part of the market for narcotic drugs.

When decriminalizing such markets, the risks involved require that a regulatory system be in place to control the negative side effects. Such regulations may limit the size of the market through a system of licensing, but may also include restrictions on the products and services, as well as on advertisement, for example. Although the principle is simple, in practice it is difficult to regulate former illegal markets effectively. One reason is that at the starting point of decriminalization, assumptions about the nature and extent of an illegal market may be flawed. Another is the problem of how to respond to changes in customer demand and the

emergence of new products and techniques. This paper explores these questions by looking into two markets in the Netherlands that have been partly decriminalized: the gambling market and the market for “soft” drugs (hashish and marijuana).

To begin with, Section 2 describes the general assumptions underlying regulation through decriminalization. Section 3 then addresses the gradual decriminalization of the Dutch gambling market since the end of World War II, and the recent developments that are now putting pressure on the regulatory regime. Section 4 discusses the decriminalization of the cannabis market, which took place at the end of the 1970s, and the changes that are now affecting the regulatory regime in this particular market. Section 5 contains some brief conclusions.

### II. THE THEORY OF REGULATION OF ILLEGAL MARKETS

A basic principle of every democratic society is that laws should be legitimate to such a degree that most of the population voluntarily agrees not to violate them. Consequently, law enforcement is ideally an *ultimum remedium*. Obviously, the authorities will confront problems if there is substantial demand for goods and services whose production and sale are illegal.

First, criminalization leads to substantial black markets. Because of the high profits at stake, individual criminals and crime groups that provide the goods and services may become more powerful and pervasive. They may even develop into organized crime syndicates that can corrupt legal markets on the one hand and the administrative and political authorities on the other. In the United States, for example, illegal gambling became increasingly organized from the 1920s onwards. Gangsters such as the notorious Al Capone operated gambling dens where punters could not only bet on the horses but also play roulette, craps and cards. In 1951, the US Senate Special Committee to Investigate Organized Crime in Interstate Commerce (more popularly known as the Kefauver Committee) concluded that gambling profits had developed “into the principal support of big-time racketeering and gangsterism” after Prohibition was repealed in 1933 [4].

Second, devoting a large part of law enforcement staff and equipment to combating illegal markets implies that they have less attention to give to other types of crime that may be equally or more harmful to society. Sending large numbers of people to prison, usually young men in these cases, is not only expensive, it may also adversely affect other parts of society. In

the United States, for example, prison sentences for drug crimes disproportionately involve young male African-Americans coming from deprived neighborhoods [5]. Furthermore, the effects of repressive action on illegal markets are modest to say the least. There are, for example, no indications that illicit drugs are less available in the U.S., or that prices are increasing [6]. Indeed, simple economics mean that as long as there is customer demand, someone will provide the illegal goods and services in the end, regardless of the risks involved. Imposing more severe prison sentences for such activities will promote substitution by others who are attracted by the potential financial profits and ultimately more people will end up incarcerated.

Leaving aside here the moral and political issues surrounding such a decision, decriminalization offers the advantage of reducing the market for criminals, preferably to the extent that they will no longer be able to make a substantial profit, as well as reducing the costs of repressive action. Customers will start buying the same product from a legal supplier, thus decreasing the market share for criminals and, hence, the workload for the police and judiciary. Decriminalization also creates the opportunity for the competent authorities to draw up specifications for the quality of the products and the services, and thus better protect the well-being of the consumer. Finally, it makes it easier to detect undesired developments, such as a growing addiction problem.

Although the basic principles of this policy are simple, there are also at least three important catches. First, legalizing an illegal product or service may expand the market – once the product or service is legal, it may also attract customers who did not want, or dare, to buy it when it was still illegal. If the number of potential customers is substantial, market growth may cause an increase in social costs, because more people will develop addiction problems, for example. Although this makes it clear that thorough market research should precede any regulation of an illegal market, this is rarely done in practice.

Second, because the market used to be illegal, bona fide operators usually lack the necessary experience or perhaps do not want to be associated with the activity, even after it is decriminalized. Therefore, there is a genuine risk that criminals will try to acquire licenses. The authorities must prevent this from happening by rigorously screening applicants.

Third, authorities must maintain an effective balance between enabling legal operators to offer attractive products or services; otherwise, criminal providers would be able to fill in the gap, and keeping social costs to a minimum. In an ideal world, authorities could keep the balance by acquiring objective information on market developments and then flexibly adapt the regulatory regime. In practice, the government is slow to respond for a number of reasons. First, it is difficult to keep track of the nature and extent of market changes. In normal economic markets, the lack of sufficient information is not a problem. There will always be entrepreneurs who want to try their luck even if they only have a faint idea of whether their product or service will attract a substantial number of customers. If they are correct, their new business will prosper, and if they are wrong, it will simply go bankrupt. The government, however, cannot engage in trial and

error entrepreneurship, and needs a higher level of certainty before it can make changes to the regulatory regime. First, it usually takes time before the necessary information is available. Second, regulatory systems are the result of careful, and often prolonged, political debate. As a rule, changes also require a legislative process as well, which means that it takes time for additional regulations to be implemented and become effective. Therefore, formerly illegal markets will always remain vulnerable to illegal operators who are usually quick to see the changes and respond to these accordingly.

Consequently, adaptation of regulatory systems to market changes is often abrupt and crude, instead of well balanced and flexible, and regulatory policies compare to maneuvering between Scylla and Charybdis. If new products or services become popular, which usually becomes evident when the number of successful illegal entrepreneurs rises, the government may decide to allow licensed operators to adjust to the change in customer preference as long as this will not lead to unacceptable social costs. Otherwise, the only option is to step up law enforcement intervention to regain control of the market. This, however, has its own particular difficulties, because once an illegal market is regulated, law enforcement will usually consider the remaining illegal niches to be a lesser priority. In the next sections, I will illustrate the aforementioned issues by looking into two examples in the Netherlands: the gambling and the soft drugs markets.

### III. THE DUTCH GAMBLING MARKET

#### A. Regulation of the gambling market

For a long time, the Netherlands had a severely restricted gambling market. Except for the State Lottery, which still exists today, all types of gambling were illegal until the end of the Second World War. Over a period of four decades, all major types of gambling were decriminalized. In 1948, betting on horse racing was legalized, followed by *pari mutuel* betting on the results of soccer matches in 1964. Casino gaming, bingo, and lotto were added to gaming legislation in 1973, followed by electronic gambling machines in 1986. Finally, in the early 1990s, instant lottery was introduced as well as several national lotteries to raise money for good causes. Except for bingo and electronic gambling machines, the regulatory system allows for only one operator to receive a license per type of game. Holland Casino, for example, is the only license holder for casino gaming, and now operates 14 casinos throughout the country. Electronic gambling machines are the only type of commercial gaming permitted; in all other cases, profits fall to the state or to good causes.

Spapens studied the effect of the decriminalization of casino gaming [7], bingo [8], lotto and sports betting [9]. His research shows that decriminalization of these types of gaming indeed diminished illegal markets, but also left niches for illegal operators that licensed companies could not cover sufficiently. For example, when the government started to regulate casino gaming in the early 1970s, an estimated 350 illegal casinos were in operation. As a rule, these were small gaming houses, comparable to the size of an average restaurant. Generally, the center of the activities was a type of observation roulette, such as *Golden Ten* or variations on that game. Customers could also play card games, such as poker or

blackjack [10]. The introduction of legal casinos did not rob the brick and mortar illegal gambling houses of their customers and by the time of the new millennium, about 75 remained. Illegal casinos serviced a particular niche in the casino market, and it proved to be very difficult to attract their customers to the official casinos. An estimated 40 percent of the visitors were unable, or unwilling, to travel to an official casino in another town. These customers were, for instance, elderly or did not possess a car. The second group of customers, also estimated at 40 percent, consisted of gambling addicts, who were no longer welcome in official casinos. Holland Casino was obliged to keep an eye on problem gambling, and could refuse admission to players who showed signs of gambling addiction. The last 20 percent of the illegal casinos' customers were criminals. They chose to avoid the official casinos because of identity checks and the fact that Holland Casino had to report transactions involving a certain amount of cash (e.g., the buying of chips) to the Ministry of Justice [9]. For a long time, it had been difficult for the police and the public prosecution service to take legal action against the gambling houses, mainly because of complex case law. In 1999, however, the Dutch Tax and Customs Administration and local authorities developed a successful multi-agency approach, which resulted in the closing of all of the illegal casinos by 2005 [7].

The government also brought bingo under a regulatory regime in 1973, with unexpected consequences. Bingo was at that time a game that was popular only in the south of the Netherlands. After its legalization, however, the game quickly became a hit in other parts of the country as well. The government had clearly underestimated the market potential of bingo. The gaming law only permitted official bingo games to offer modest prizes, and criminals quickly started to attract players by offering much higher wins. At the end of the 1980s, criminal involvement had led to several shootings resulting from turf wars and forced the authorities to crack down on the problem. Afterwards, a small number of unlicensed commercial bingo operators were able to continue, for example in Amsterdam where for a long time the local authorities did not consider bingo to be a substantial problem. More recently, however, they changed their minds and used the aforementioned multi-agency approach to close the remaining bingo venues [8].

Next, the government regulated electronic gambling machines in 1986. The gambling law already permitted such machines as long as they did not pay out in cash but in credit points allowing for extra games. In many bars, however, the bartender would pay out the credit points accumulated, and then reset the machine to zero by means of a 'knock-off' switch. Crime groups reputedly controlled the placing of such specifically adapted gambling machines. Regulation, therefore, seemed to be a sound policy. The authorities, however, made two critical mistakes. They allowed the market for electronic gambling machines to expand too much, and they did not effectively screen applicants for licenses.

The regulatory system for electronic gambling machines is more liberal than the monopoly system that applies to, for instance, casino gaming. In principle, an unlimited number of private companies can apply with the Ministry of Justice for a

license to rent out electronic gambling machines. With respect to the installation of the electronic gambling machines, local authorities have to issue a license. The machines were set up in gambling arcades and in establishments like bars, restaurants, discotheques, snack bars, and sports canteens as well as in community centers. The widespread availability of electronic gambling machines almost immediately caused a sharp increase of addiction problems, particularly amongst young males. An important measure to curb addiction was the barring of electronic gambling machines from establishments that were also accessible for youth, such as snack bars and sports canteens. The effect of this has been that the number of young people seeking help has steadily declined since 1994, and so did the number of electronic gambling machines [11].

However, it took much more time to correct the second mistake. The lack of screening of applicants for licenses resulted in a number of persons who were involved in criminal activities entering the legal market. In Amsterdam, for example, several gambling arcades ended up in the hands of persons who were members of organized crime groups. In 1993, half of all electronic gambling machines in Amsterdam – 3,100 in all – were said to be controlled by five criminal organizations [12]. From the mid-1990s onwards, the municipality of Amsterdam started to screen the holders of licenses – these need to be renewed periodically – more effectively, but by then the original criminal owners had transferred "ownership" to family members and other straw persons. It took a lot of effort and lengthy proceedings to prove that economic ownership had not changed, in order to revoke permits or to refuse their renewal. Sometimes, the authorities had no other option than to buy out the owners and then close the establishment.

Finally, illegal lotto and sports betting also continued after the government regulated these games, albeit on a small-scale. Here, the primary explanation is the fact that illegal operators offered specific products that were unavailable with the official operators. The illegal lotto offered much smaller prizes than the official lotto, but the game was still attractive to customers because of the higher chances of winning. Furthermore, a social component played a role, because runners usually sold illegal lotto tickets to members of their social network. For many years, operators of illegal soccer betting rings accepted higher bets than the official soccer Toto and offered more flexibility. Nowadays, however, illegal betting rings experience stiff competition from online gambling operators. Illegal lotto is played mainly in the major cities of the Netherlands, and continues because investigation is a low priority with the enforcement agencies. In the Netherlands, the principle of opportunity applies, and the public prosecution service chooses to allocate its resources to those types of crime that it considers most harmful to public order. Illegal lotto is not considered a serious threat to the integrity of society, and is not associated with violence and fraud. Furthermore, why should the investigation of illegal numbers games have priority if people can buy tickets in the legal lotto on every street corner [9]?

#### *B. The effects of online gambling*

As described above, regulating an illegal market depends on a system of licensing and on restricting the activities of legal

operators. Holland Casino, for example, is not permitted to open more than 14 casinos, the prize money bingos may offer is limited, and this also applies to maximum amount of money one may wager in the lotto or in the soccer Toto. Naturally, all of these measures are intended to limit the risk of gambling addiction. The system fails, however, in the case of online gambling. The first gambling website appeared in 1995, and online gambling quickly developed into a multibillion-dollar business. The Internet not only modernized existing games of chance, but it also truly globalized the gambling market. Consequently, online gambling put considerable strain on the effectiveness of common regulatory instruments. Nowadays, an operator need only acquire a license for online gambling in a single country to attract players from all over the world, although it may be formally illegal for it to do so in jurisdictions that prohibit Internet gambling.

The emergence of Internet gambling and its exponential growth have been one of the most significant and contentious developments in gambling over the past two decades. Although it appears to be economically significant, little is known about the Internet gambling industry, its customers, or its social and economic impacts [13]. In 2006, statistics showed there were as many as 2,500 gambling websites operating, consisting of 1,083 online casinos, 592 sports and race books, 532 poker rooms, 224 online bingo sites, 49 skill game sites, 30 betting exchanges, 25 lottery sites and 17 backgammon sites [13]. In the same year, estimates of online gambling revenues amounted to \$7.6 billion in the USA, \$16 billion in the Asia Pacific region and \$6 billion in Europe [14].

The operators of gambling websites often register in exotic countries or self-governing territories within countries. The remote gambling industry is very fluid; there are low barriers to entry and exit, and this means that operators will probably move to jurisdictions that take a *laissez-faire* approach to licensing if the regulatory burden in the host country becomes too onerous. In 2006, for example, Antigua (537), Costa Rica (474), the Kahnawake Mohawk Territory in Canada (401) and Curacao (343) hosted the most websites [15]. The Internet has greatly reduced the effectiveness of restrictive gambling policies. It has also interfered with traditional regulatory instruments based on limiting the number of licensees and on excluding foreign operators. Understandably, the loss of control has raised concerns with the governments of countries that are the main target markets for online gambling operators.

Not surprisingly, this has created considerable concern about the possible involvement of criminals in online gambling and about the integrity of the games on offer. Furthermore, it is much more difficult to prevent addiction when players can access gambling websites at any given hour of the day [16]. One of their primary concerns is the risk of criminal groups owning gambling websites. It is illegal to offer online gambling facilities to the inhabitants of countries that do not allow gambling, and *bona fide* companies are prevented from entering the market there. Such constraints do not deter crime groups, of course. Furthermore, most jurisdictions hosting gambling websites scarcely screen the backgrounds of applicants for operating licenses, if at all. Criminals who own gambling websites can generate income with little or no risk of apprehension and prosecution. In addition, they also gain

access to players' credit card and other information, which they can then use to skim the customers' bank accounts and to commit identity fraud, although there is no hard evidence that this has actually happened. More importantly, the games themselves can be manipulated. For example, criminal operators can adapt the gaming software to their own advantage. Even in online poker rooms, the provider can introduce a 'virtual player of the house' into the game – a computer program that can manipulate the outcome at will – without the human players noticing [12].

In response to the perceived risks of online gambling, the United States government has tried to impose restrictions, but with only limited success so far. First, it tried to prosecute foreign-based suppliers of online gambling. In 1998, federal prosecutors charged 21 US citizens connected to offshore Internet gambling with violations of the Wire Act, which prohibits anyone in the business of betting or wagering from using a wire communication facility in interstate or foreign commerce to transmit bets or wagers. Only one of the indicted, who had operated from Antigua, contested the case in court and was convicted [17]. In response, however, Antigua initiated the dispute resolution process of the World Trade Organization (WTO), believing the US sentence in this case to be in violation of the General Agreement on Trade in Services (GATS). Ultimately, the WTO ruled in favor of Antigua. The US, however, failed to comply, and the WTO subsequently awarded Antigua the right to suspend obligations under the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS) up to a level of \$21 million annually.

Next, in 2006, the US government adopted the Unlawful Internet Gambling Enforcement Act (UIGEA), which prohibits the acceptance of specified forms of payment for unlawful Internet gambling by a business of betting or wagering. The Act took aim at the Achilles heel of gambling websites: the fact that payment via the Internet mostly involves banks that *do* fall under the jurisdiction of the players' country of residence. As a result, *bona fide* gambling websites immediately stopped taking bets from US customers. Non-publicly traded websites, however, continued to accept US players, but as of mid-2010, not one of these has been indicted under the UIGEA. In any case, Internet gambling sites can still prevent banks from recognizing transactions as gambling-related, for example by using online payment providers as intermediaries [18].

The attitude toward online gambling is less clear-cut in the EU. Some of the Member States, such as Malta, Austria and the United Kingdom, as well as self-governing territories such as Gibraltar and the Finnish island of land, allow online gambling, although for instance Malta and Gibraltar only issue licenses under the condition that the online gaming companies do not target customers in their jurisdictions. Other countries follow a more restrictive policy, and they particularly struggle with the question how to respond to these developments. In the Netherlands, legal action against foreign operators has proven to be very difficult, although the courts have established that online gambling companies that are not licensed in the Netherlands – which is impossible because online gambling is not included in the Gambling Act – are breaking the law. Up to now, the public prosecution service has not instituted criminal proceedings against online gambling companies. Instead, the

government is now opting for a combination of including online gambling in the Gambling Act and issuing a limited number of licenses on the one hand, while blocking non-licensed foreign operators' financial transactions on the other. This bill has yet to pass parliament, however [9].

A problem that remains is the screening of foreign applicants for a Dutch online gambling license. In the Netherlands, screening involves checking criminal records and financial information provided by the Dutch Tax and Customs Administration, for example. However, the lack of applicable treaties and other legal instruments hamper the cross-border exchange of such information if it is to be used for the purpose of issuing licenses. The latter is considered as an administrative action, which does not relate to the fiscal or criminal offences for which the legal framework is designed.

#### IV. THE DUTCH SOFT DRUGS MARKET

##### *A. Regulation of the soft drugs market*

The Netherlands is unique in that it also applies a regulatory system to the narcotic drugs market, although it only covers soft drugs (hashish and marijuana). Furthermore, the system only applies to the sale of soft drugs and not to their import or production. As far back as the end of the 1960s, the Dutch government decided that a uniformly repressive policy towards narcotic drugs was undesirable [19].

As in other countries, youth culture began to develop in the Netherlands from the 1960s onwards, and this included an increase in the use of narcotic drugs. By today's standards, however, overall drug use remained modest and was mostly confined to hashish and marihuana. The users were predominantly young people in the major cities, and students in particular [20,21]. The picture changed in the early 1970s when heroin addiction became a serious problem. Two committees studied measures intended to prevent drug addiction. The first reported in 1971 and it concluded that the use of cannabis was mainly a sub-cultural phenomenon and that moral factors rather than objective dangers had been the drivers behind its criminalization [22]. The committee also stated that a policy of repression would result in an endless negative spiral, whereas it assumed that the market for soft drugs would remain limited in size [23]. The second committee reported in 1972, and it too concluded that an exclusively penal law approach to drug users would be inadequate [22]. Both committees recommended making a distinction between cannabis and other illegal drugs, as well as between using and dealing narcotic drugs.

Over the next four years, the proposals became the subject of political discussion. On the one hand, the Dutch parliament unanimously agreed that drug addicts should be helped or treated, and not be targets for law enforcement [22]. On the other, they decided that the trafficking of narcotic drugs should be punished more severely, and that the police and the judicial authorities should step up their investigation. With regard to cannabis, the government arrived at a compromise. Total legalization was impossible because it would violate the United Nations Single Convention on Narcotic Drugs to which the Netherlands was a party. Instead, cannabis was to remain illegal, but the judicial authorities would no longer prosecute

the possession, use and sale of consumer quantities. In 1976, the distinction between soft drugs (i.e. hashish and marihuana) and hard drugs (all other narcotic drugs) was added to an amended Opium Act [19].

The Board of Procurators General issued a directive stating that the public prosecution service would no longer prosecute soft drugs possession as long as the amount did not exceed 30 grams. The decision was not based on a legal provision arising from political debate, but on a directive drawing on the principle of opportunity, although the Board would of course never issue such a directive without political consent. According to Van de Bunt, the directive was actually intended as a temporary stopgap because the Dutch authorities believed that the world community would soon take a similar approach to hashish and marihuana and amend the Single Convention. After that, a proper regulatory regime would become possible [23].

Logically, the chosen policy also involved deciding how to deal with the persons supplying soft drugs to the customer. In practice, youth activity centers and concert venues, for example, had started to appoint "house dealers" in order to avoid competition and turf wars between different suppliers. Rather more unexpected was the emergence of "coffee shops" that sold soft drugs. In 1979, the Board of Procurators General issued another directive ordering the authorities to refrain from active investigation of house dealers and coffee shops unless they put public safety or health at risk, or openly tried to promote and expand their business. There were no regulatory measures taken with regard to the supply side [19]. At that time, criminal groups smuggled in all of the hashish and marihuana from abroad and logically a directive towards not prosecuting such groups was impossible.

The first coffee shops opened in Amsterdam, but other Dutch towns were soon to follow. By 1990, the number of shops had increased to about 300 in Amsterdam, and to about 1,500 in total in the Netherlands [24]. On the positive side, the coffee shops now served most of the soft drug customers and largely replaced the house dealers and street dealers. The opposite side of the coin – scarcely recognized at the time – was that criminal groups that already controlled much of the import of hashish and marihuana from source countries such as Pakistan, Morocco and Lebanon were also the economic owners of many of the coffee shops [19]. At that time, a system of licensing was not yet in place, so it was impossible to screen the backgrounds of coffee shop operators.

Although the regulatory system was not the result of careful design, and therefore had severe limitations, it was considered successful. The number of heroin addicts in the Netherlands remained relatively low, and the number of soft drug users was not exceptionally high when compared to other countries of the European Union [25]. Yet, comparable to the case of electronic gambling machines, the authorities had to implement additional measures to scale-down access to soft drugs and to close coffee shops that were owned by persons connected to organized crime.

To begin with, the Dutch consumer market for hashish and marihuana gradually changed at the end of the 1980s. In the

1960s and 1970s, most cannabis users had been well-educated youth from the higher social classes [20]. From then on, cannabis use increased among the lower social and economic classes whereas it steadily decreased amongst other youth [26]. The authorities responded to this development by imposing additional restrictions on the coffee shops. In 1991, the Board of Procurators General introduced the “AHOJ-G” criteria, which raised the minimum customer age from 16 to 18 and reduced the maximum amount of soft drugs coffee shops could sell per customer from 30 to 5 grams. In addition, the local authorities could also decide to close a coffee shop temporarily if visitors caused too much nuisance [19].

Next, local authorities, to begin with in Amsterdam in 1992, introduced a system of licensing of coffee shop owners. It was, of course, not possible to license the sale of soft drugs, because that would have been in violation of existing conventions. However, coffee shops also sold beverages and food, which is subject to the Alcohol Licensing and Catering Act and requires a license. Consequently, the municipality started to screen the backgrounds of coffee shop operators and refused licenses to those who had been involved in criminal activities. In 2003, the BIBOB Act substantially expanded the possibilities for the vetting of applicants for licenses, and business relations with known criminals, particularly financial agreements, are now sufficient grounds to refuse or revoke a license. The authorities can even use intelligence provided by trustworthy criminal informers as evidence in licensing procedures.

Of course, screening that is more thorough did not immediately free the coffee shop sector of criminal involvement. Indeed, coffee shop operators usually do their utmost to avoid direct involvement in illegal activity, but it does not solve the problem of criminals being the ultimate beneficiaries of such shops. Analysis of coffee shops in the Amsterdam Red Light District revealed that most known criminals or persons closely affiliated with organized crime groups transferred ownership to their wives, lovers or family members back in the early 1990s just prior to the introduction of the system of licensing [27]. Generally, the number of coffee shops in the Netherlands steadily decreased since 1999 [28]. Now, only one-fifth of the country’s municipalities permit coffee shops to operate, and most decreased their number over the years by prohibiting replacement if a coffee shop closed its doors. Local authorities also shut down several coffee shops every year, mostly because the owners violate license conditions or commit tax fraud. In most cases, the municipality will not allow another operator to start a new coffee shop in the same location after it has been forced to close.

#### *B. The effects of technical developments and internationalization*

Since the mid-1990s, new developments occurred that caused problems for the Dutch approach to the sale of hashish and marihuana. As with the gambling market, this

predominantly resulted from technical innovations and internationalization. First, the introduction of indoor cultivation methods gradually turned the Netherlands into a major producer of marihuana. Second, the abolition of fixed border controls within the Schengen zone of the European Union increased the amount of narcotic drugs exported from the Netherlands as well as imported and manufactured in the country.

For a long time, homegrown Dutch cannabis was of poor quality and could not compete with imported hashish and marijuana. This changed around 1990, with the introduction of techniques for indoor growing [29]. In 1991, the Dutch police discovered 50 cannabis nurseries, with a total of about 70,000 plants [30]. Hobby growers, often themselves users, were the first to experiment with indoor cannabis cultivation. They set up small-scale grow operations in their own private homes and started to sell their surplus to the coffee shops. In the mid-1990s, the authorities welcomed this development, because it made the shops less dependent on wholesale criminal importers. At the end of the decade, about two-thirds of the soft drugs sold at coffee shops were domestically produced [31,32].

However, it did not take long before organized crime groups also entered the cannabis-growing market. At first, they started setting up nurseries in other people’s private homes. Later on, they started large-scale plantations and opened grow shops, where potential growers could obtain all legal growing materials such as pots, soil and growing lamps as well as cuttings, which are illegal. Growers could also receive all the advice they needed from the grow shop, and sell their harvests there. The criminal group who owned the grow shop would then sell the high-quality cannabis to coffee shops, and smuggle the medium and poor quality abroad. A turnover of 100 to 200 kilos per week per grow shop was not unusual. Financial investigations revealed that sometimes criminal groups amassed tens of millions of euro in the span of just a few years [33]. On average, the Dutch police uncover about 5,500 cannabis plantations annually, ranging in size from 50 to over 50,000 plants. Although cannabis cultivation is also on the rise in other EU Member States, the number of nurseries found per capita is still by far the highest in the Netherlands [34].

A second important development undermining Dutch drug policy is the sale to foreign customers. Over the years, the Netherlands has developed into a “drug supermarket”, particularly for Germany, Belgium, France and the United Kingdom. Even in the 1970s, backpacking youths from the entire Western world favored Amsterdam as a destination, among other things because of the opportunity to try out hashish and marijuana without the risk of arrest. From the mid-1990s onwards, drug tourism increased. An important explanation was the abolition of fixed border checks in 1995, following the Schengen Agreement. In addition, the 1990s and most of the first decade of the new millennium was an era of economic prosperity, which also furthered mobility. Now,



estimates are that over 10,000 foreign drug tourists visit the Dutch border areas every day. Slowly, the influx started to cause problems that the local authorities, particularly in the densely populated southern border area, could no longer ignore.

First, most coffee shops were located in the centre of the border towns, and the many drug tourists inevitably caused parking and other nuisance problems to the local population. Second, drug tourism led to the development of mega coffee shops. One of these shops welcomed an average of 2,500 customers daily from Belgium and France. If every customer bought 5 grams, annual turnover would amount to an estimated 4.5 metric tons of cannabis. Clearly, such a shop had come a long way from the small-scale outlets the Dutch authorities decided to allow in the early 1980s. Third, a parallel infrastructure of drug-dealing houses developed, where customers could acquire larger amounts of both soft and hard drugs. The Schengen agreement greatly reduced the risk of apprehension at the border and also made it attractive for addicts living further inland in Germany and France to make the trip and take home a week's or a month's supply for personal use. Finally, small dealers, also particularly from Germany and France, started to acquire their weekly or monthly shopping lists directly from Dutch suppliers. Such shipments might comprise a mix of a few kilos of cannabis, 100 grams of cocaine, several hundred ecstasy pills and 50 grams of heroin, depending on the dealer's customer base [35].

Just as with gambling, the government has a number of theoretical options for responding to this development. The first option, further decriminalizing the market, such as by regulating the supply of drugs to the coffee shops, is politically unfeasible. One of the reasons for this is neighboring countries' highly critical view of the existing Dutch drug policy. The second option, trying to "seal the borders," in this case by allowing only Dutch residents access to coffee shops, will be attempted in the near future, but it is already under fire due to fear that it will boost the illegal market. The third path, stepping up law enforcement action to compensate for the "market imperfections" that have developed, has also been chosen. It took a very long time, however, before the police and the public prosecution service were convinced that soft drugs, particularly the growing of cannabis, had developed into a problem: not because of the product itself, but because it had turned into a major money-maker for all sorts of criminal groups. The effects of law enforcement action are difficult to assess, but they seem to be relatively limited. The enforcement agencies were not permitted to hire extra personnel and until now, the time-consuming investigations resulted in only modest prison sentences.

#### CONCLUSION

While regulation may be an effective strategy to curb illegal markets so that they are no longer profitable for criminals, niches for illegal operators will always remain. A

first important prerequisite is a tailor-made regulatory regime, including a system of licensing and vetting, designed to exclude criminals from the market. Furthermore, the authorities must have a clear picture of the market potential of a specific illegal product or service once it is decriminalized. A second important prerequisite is the flexibility to adjust the regulatory system. Regulated markets remain dynamic, and changing circumstances may create new opportunities for criminals. In practice, however, flexible responses to market changes are difficult, mainly because of political considerations, and take time to become effective. Furthermore, international developments may undermine even carefully designed regulatory systems. To compensate for unforeseen developments, governments must retain the ability to intervene by means of law enforcement action. The examples described here clearly show that all of the problems associated with 'planned economies' also apply to the regulation of illegal markets. This, of course, does not imply that regulation is impossible. However, it does underline that besides political convictions, objective indicators for the adaptation of regulatory regimes need to be included in the discussion.

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